DOCKET FILE COPY ORIGINAL

RECEIVED

OCT - 7 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

LAW OFFICES

ROSS & HARDIES

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

888 SIXTEENTH STREET, N.W.
WASHINGTON, D.C. 20006-4103
202-296-8600

TELECOPIER
202-296-8791

150 NORTH MICHIGAN AVENUE
CHICAGO, ILLINOIS 60601-7567
312-558-1000

PARK AVENUE TOWER
65 EAST 55TH STREET
NEW YORK, NEW YORK 10022-3219
212-421-5555

580 HOWARD AVENUE
SOMERSET, NEW JERSEY 08875-6739
908-563-2700

STEPHEN R. ROSS

October 7, 1993

HAND-DELIVERED

William F. Caton
Acting Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 - Rate Regulation
MM Docket No. 92-266

Dear Mr. Caton:

Enclosed on behalf of the Medium-Sized Operators Group, are the original and four copies of the Group's Reply Comments in the above-referenced proceeding.

Please address any questions concerning these Comments to the undersigned.

Cordially,

Stephen R. Ross

SRR/sdb
Enclosures

No. of Copies rec'd 044
List ABCDE

DOCKET FILE COPY ORIGINAL

RECEIVED

OCT - 7 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
	)	
Rate Regulation	)	

REPLY COMMENTS OF THE MEDIUM-SIZED OPERATORS GROUP

The medium-sized operators group[1] ("the Group"), by its attorneys, hereby submits the following reply comments on the Federal Communications Commission's ("FCC or Commission") Third Notice of Proposed Rulemaking, ("NPRM") FCC 93-428, MM Docket No. 92-266, released August 27, 1993.

Specifically, the Group responds to the joint comments filed by the cities of Austin, Texas; Dayton, Ohio; Dubuque, Iowa; Gillette, Wyoming; Montgomery County, Maryland; St. Louis, Missouri; and Wadsworth, Ohio ("the Cities"). The Cities assert, among other things, that the FCC's benchmark rates are "high enough to cover [operators'] costs, including depreciation of capital plant and a return on plant investment", and therefore, no adjustment to the benchmarks to account for the costs of

---

[1] The members of this group include: Adelphia Communications Corporation, Bresnan Communications Company, Cablevision Systems Corp., Columbia International, Inc., Falcon Cable TV, Hauser Communications, InterMedia Partners, Jones Spacelink, Ltd., Lenfest Communications, Inc., Marcus Cable, Prime Cable, RP Companies, Inc., Simmons Communications, Inc., Star Cablevision Group, Sutton Capital Associates, Triax Communications Corp., United Video Cablevision, Inc., and US Cable Corporation.

upgrades is necessary. Cities' comments at pp. 3-4. In support of their assertion, the Cities provide a report by Mr. Jay Smith ("Smith Report") who has undertaken a review of the Ernst & Young's ("E&Y") report submitted by the Group with its supplemental comments on August 4, 1993.

E&Y's report, prepared with considerable effort by expert economists and accountants, demonstrated that the benchmark rates typically do not compensate for system rebuild costs and incremental programming costs. E&Y's data showed that the actual rebuild costs per channel per subscriber compared with the additional revenue per channel permitted under the benchmarks left the eight cable systems surveyed with margins, <u>before</u> programming costs, marketing and overhead costs, of between -$0.09 to $0.08. E&Y Report at p.12.

By manipulating E&Y's data, the Cities have attempted to show that the benchmarks sufficiently compensate operators for all of their costs, including depreciation and costs of upgrades, and for a return on their plant investments. To do this, the Cities have relied on patently absurd assumptions, the most ridiculous of which is "[w]hile <u>costs</u> were not specifically surveyed, it is fair to assume that the <u>prices</u> that were charged by the surveyed systems were high enough to cover costs, including depreciation of capital plant and a return on plant investment." Smith Report at p. 3. Therefore, the Report concludes, embedded capital costs are already adequately reflected in the existing benchmark rates, and providing an additional rate increment for upgrade costs would be "inappropriate." Id.

This assertion is without foundation in light of the fact that the cable industry has significant current and accumulated losses. The Commission itself has recognized that "large financial losses are common across the industry." Cost-of-Service NPRM, MM Docket No. 93-315 at ¶ 39, n.44. If Mr. Smith's statement were true, then cable operators would not be arguing in the Commission's cost-of-service proceeding that intangibles and accumulated losses must be recoverable in the rate base. In fact, in the Group's reply comments in the cost-of-service proceeding, E&Y's cost-studies of nine cable systems operated by Group members showed that accumulated losses alone ranged from $2,678,000 to $91,692,000. E&Y's "Cost of Service Regulation for Cable Television Operators," MM Docket No. 93-315, September 13, 1993, at p.13, Table 1.

Moreover, largely due to accumulated losses, the practice of phasing-in rate increases following rebuilds and upgrades is common among cable operators. The FCC itself recognized this in the instant NPRM by proposing transitional rules for operators that recently upgraded their systems. "[S]ome cable operators . . . may have foregone needed rate adjustments, such as after a system upgrade, to avoid subjecting subscribers to immediately sharp rate increases in anticipation of a series of more gradual rate increases over time." First Order on Reconsideration, at ¶ 14, n.25.

Mr. Smith's report is fundamentally flawed in other respects as well. First, using E&Y's data Smith spreads the cost of an upgrade over the entire channel capacity of the system, rather than over only the incremental channels. While Smith attempts to justify changing the denominator or divisor by asserting that all the channels on the system benefit from the capital improvement, this method does not change the fact the cost of the upgrade must be recovered only from the additional revenue generated by the new channels. Smith also ignores the economic disincentives of his approach. If a cable operator cannot recover the cost of the upgrade from the additional revenue generated by the additional channels, then there is no incentive to upgrade the system. In addition, Smith ignores the fact that subscribers will receive their alleged improved signal quality over the existing channels at a per channel rate, which under the benchmark formula, actually declines as channels are added.

Second, Smith reduced the 20 percent factor applied by E&Y to 15 percent, asserting that his figure "better reflects" the FCC's proposed rate of return of between 10 and 14 percent. What Mr. Smith apparently fails to understand is that taxes would be paid out of the 20 percent factor, which would leave operators with approximately a 12 percent rate of return assuming a 40% combined federal/state corporate tax rate, which is in line with the Commission's suggested guideline. In contrast, Smith's approach would leave operators with only approximately a 9 percent rate of return after paying the corporate tax rate, which notably is a rate of return well below that which is generally allowed the telephone companies.

Finally, Smith asserts, without any factual support, that the average per subscriber per channel cost of <u>additional</u> satellite programming will likely be less than the current average cost of \$0.20 because "popular services which can command higher prices are already carried on most systems." Smith Report at p. 2. There is no evidence in the record or provided by the Cities to support such a statement, and in fact many of the recent new cable channels developed to respond to retransmission consent-related demands verifiably have costs per channel substantially in excess of \$0.20. Moreover, as demonstrated by the Group in its comments in this proceeding and contrary to Smith's assertion, the FCC's proposed adjustment to the benchmarks to account for programming costs will <u>not</u> "assure that operators are compensated for the costs of programming." <u>Id</u>. The ability of operators to recover their satellite programming costs is especially important since cable operators are at this time prohibited from passing through the cost of retransmission consent fees.

In sum, the Cities' purported economic review of E&Y's report demonstrates their fundamental lack of understanding of the industry's financial structures and practices. The manipulation of E&Y's data by the Cities is wholly self-serving and without merit.

Respectfully submitted,

THE MEDIUM SIZED OPERATORS GROUP

By: ______________________

Stephen R. Ross
Kathryn A. Hutton

ROSS & HARDIES
888 16th Street, N.W.
Suite 300
Washington, D.C. 20006
(202) 296-8600

Dated: October 7, 1993

CERTIFICATE OF SERVICE

I, Susan D. Benson, a secretary of the law office of Ross & Hardies, do hereby certify that I have this 7th day of October, 1993, served by hand a copy of the foregoing "Reply Comments of the Medium-Sized Operators Group" to:

Chairman James H. Quello
Federal Communications Commission
1919 M Street, N.W.
Room 802
Washington, D.C. 20554

Commissioner Andrew C. Barrett
Federal Communications Commission
1919 M Street, N.W.
Room 826
Washington, D.C. 20554

Commissioner Ervin S. Duggan
Federal Communications Commission
1919 M Street, N.W.
Room 832
Washington, D.C. 20554

Roy J. Stewart
Federal Communications Commission
1919 M Street, N.W.
Room 314
Washington, D.C. 20554

Nicholas P. Miller
Joseph Van Eaton
Lisa S. Gelb
Miller & Holbrook
1225 19th Street, N.W.
Suite 400
Washington, D.C. 20036

Susan D. Benson